Northern Trust

DAILY GLOBAL
COMMENTARY

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Second-Quarter GDP – The Parachute Has Opened

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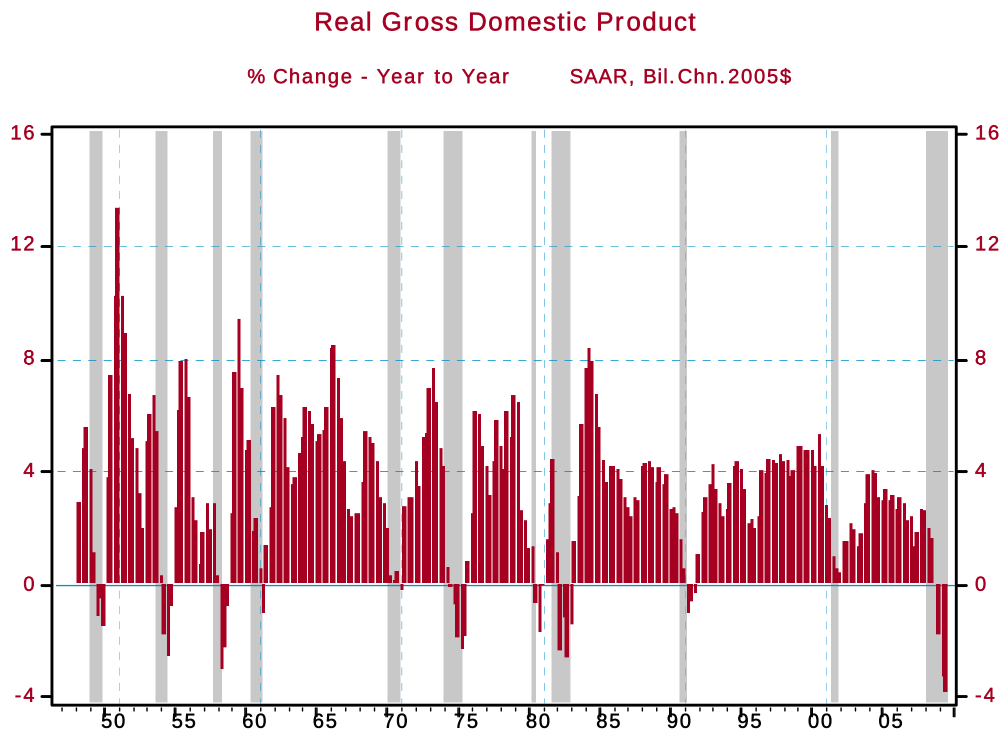
The Commerce Department's first guess at second-quarter real GDP has the U.S. economy contracting at *only* 1.0% annual rate compared to the first quarter's downwardly revised annualized contraction of 6.4% (previously reported as a 5.5% rate of contraction). On a year-over-year basis, real GDP was down 3.9% in the second quarter, the most severe year-over-year decline in the post-WWII era (see Chart 1).

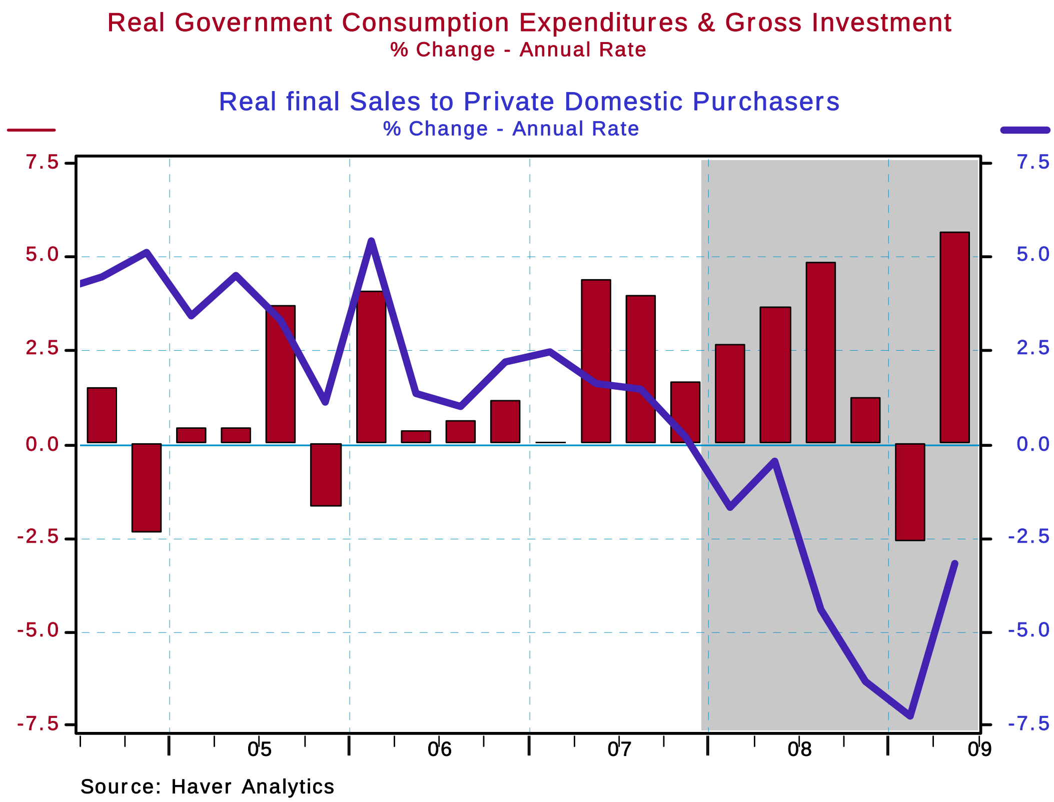
Chart 1



Source: Bureau of Economic Analysis /Haver Analytics

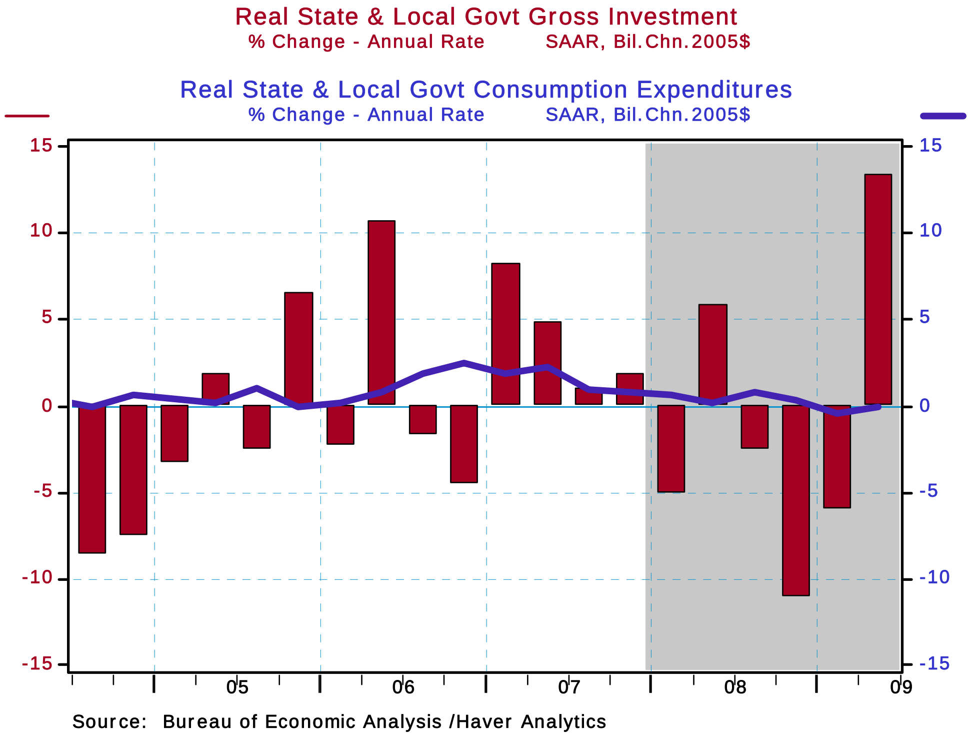
In this advance estimate of second-quarter real GDP, the Commerce Department does not yet have June data for inventories or net exports. So, let's look at the data that Commerce *thinks* it has – final sales (i.e., excluding inventories) to domestic purchasers. The rate of descent here, too, has slowed – an annualized contraction of just 0.2% in the second quarter vs. a 4.1% rate of contraction in the first quarter. A step up in government expenditures – federal as well as state & local – played a big role in moderating the contraction in domestic final demand. As shown in Chart 2, real government expenditures rebounded with annualized growth of 5.6% in the second quarter. Real private domestic expenditures on final goods contracted at an annualized rate of 3.2% – still very weak, but not as weak as the first quarter's annualized contraction of 7.3%.

Chart 2



In the second-quarter rebound in real government expenditures we see the early spending effects of the federal fiscal stimulus program, *not* so much in federal expenditures, but in state & local government expenditures. As shown in Chart 3, real state & local government gross investment (i.e., infrastructure spending) soared to an annualized rate of 13.3% in the second quarter while real general operating expenditures were nearly flat. With state & local fiscal situations in dire straits, where did these governments get the funding to engage in so much investment, "gross" as it might be? Most likely directly from the U.S. Treasury or indirectly from the U.S. Treasury from "Build America" bonds – taxable bonds issued by state & local governments but with a Treasury rebate to the issuers. Also, state & local government operating, or consumption, expenditures likely would have been weaker had it not been for U.S. Treasury funds transfers to these government entities. Going forward, federal government nondefense gross investment expenditures are likely to grow rapidly rather than contract at the 0.9% annualized pace that they did in the second quarter. President Obama is urging federal agencies to step up the pace of actual spending of previously-authorized expenditures. Say no more.

Chart 3



There was reported a marked slowing in the rate of decline of business capital spending – on structures as well as equipment & software (see attached table for details). With regard to structures, I would expect the rate of decline to gather renewed downside momentum in the second half of the year. Commercial real estate cycles tend to be relatively long and severe. With commercial property vacancy rates rising and with commercial mortgage lending restricted, it is hard to see that the end of contraction in this sector is remotely near. I am less negative about the outlook for equipment & software spending, but again, with as much excess capacity as is being reported, it is unlikely that the contraction in this sector will end until the fourth quarter.

It takes a little over six months to finish a single-family dwelling once it is started. Single-family housing starts have increased in each of the four months ended June. Thus, residential investment expenditures are likely to continue contracting in the third quarter, before leveling out in the fourth quarter. But the third-quarter contraction is expected to moderate from the second quarter's 29.3% annualized rate of decline.

Despite stepped up government transfer payments to households and reduced federal tax withholdings, real personal consumption expenditures could not manage to post any growth in the second quarter. But the second-quarter annualized decline of 1.2% in real consumer spending was a relative improvement over the second half of 2008's annualized contraction of 3.3%. The federal government's "cash-for-clunkers" program, which is likely to be enlarged from $1 billion to $3 billion, will boost third-quarter motor vehicle sales. But this will be borrowing from future sales. With households still in a pinching pennies mode, with the unemployment rate headed higher and with lenders not exactly falling over themselves to advance households credit, real consumer spending may be nearing a period of stabilization, but likely is many quarters away from a shop-until-you-drop phase.

As we said at the outset, the Commerce Department does not yet have June inventories and net exports data. So, the advance report for these GDP components has to be taken with an even smaller grain of salt than the other components. With this proviso in mind, it was encouraging to see the annualized rate of contraction in real exports slow from nearly 30% in the first quarter to a mere 7% in the second quarter. With a number of developing economies experiencing economic recoveries, such as China, Singapore and South Korea, the change in U.S. exports might break into the plus-column by the end of this year.

Lastly, the volatile swing factor, private business inventories shaved 0.8 of a point off of second-quarter real GDP after buzz-cutting it 2.4 points in the first quarter. Detroit's bankruptcy woes played a role in the continued decline in private business inventories. GM's longer-than-usual summer shutdown this year might hold down seasonally-adjusted motor vehicle inventories in the third quarter, too. But one of these quarters, perhaps the fourth quarter of this year, darned near every business in America will decide to do a little restocking of the shelves, and real GDP growth will skyrocket. Investor beware.

In sum, the worst is over, but the best is not yet at hand. The imminent recovery will take hold not with some sustainable explosion in one sector or another, but because some hitherto really weak sectors will stabilize and/or grow a little.

In addition to providing us with its first guess at the economy's second-quarter performance, the Commerce Department also provided us with some of its new guesses as to how the economy performed in the years 2006 through 2008. As the data below show, economic activity in 2008 was a lot worse than Commerce had previously guessed it was. But a lot of you knew that already.

Yearly percent changes

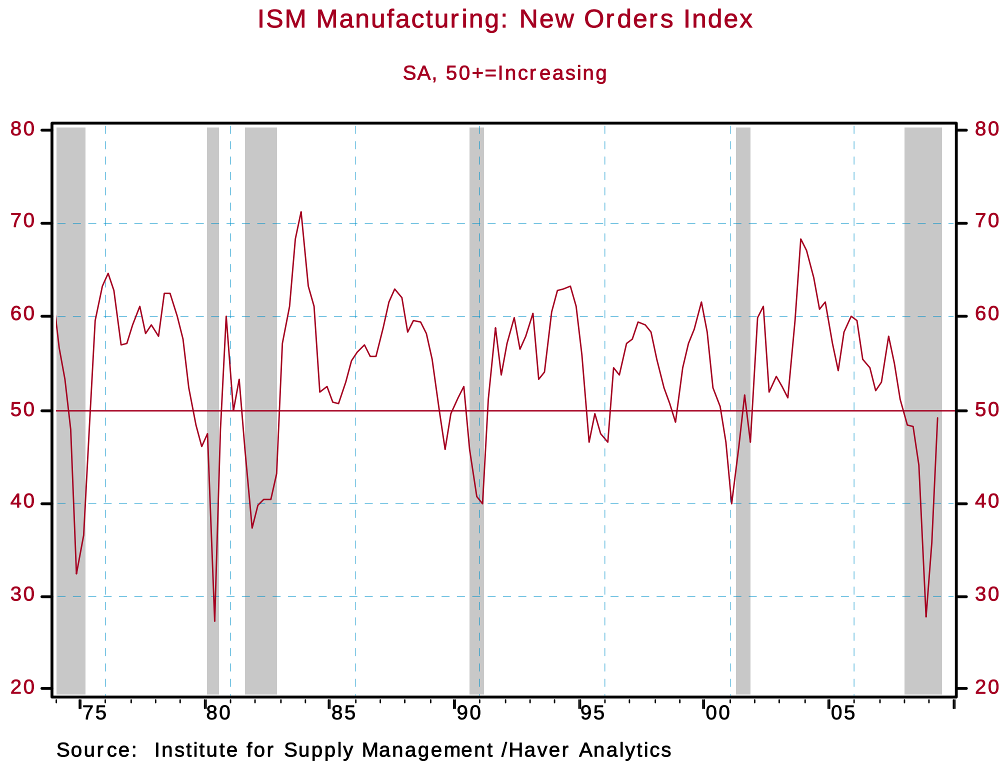
	2008	(Prev)	2007	(Prev)	2006	(Prev)
Real GDP	0.4	1.1	2.1	2.0	2.7	2.8

Quarter-to-quarter real GDP percent changes

	Q1	(Prev)	Q2	(Prev)	Q3	(Prev)	Q4	(Prev)
2008	-0.7	0.9	1.5	2.8	-2.7	-0.5	-5.4	-6.3
2007	1.2	0.1	3.2	4.8	3.6	4.8	2.1	-0.2
2006	5.4	4.8	1.4	2.7	0.1	0.8	3.0	1.5

This revisionism on the part of Commerce is why I like other sources of data, such as the Institute for Supply Management (ISM). Other than annual updates of seasonal adjustment factors, the data provided by this source *never* get revised. Chart 4 shows that the ISM survey results indicated a very serious economic downturn was underway in 2008. And now the Commerce Department confirms it. I eagerly await what the ISM has to tell us about July economic conditions in its release on Monday, August 3.

Chart 4



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Real Gross Domestic Product 2009:Q2 Advance Estimate

	Levels (Billions of chained 2000 dollars)			Percent Change (SAAR)		
	08:4 Final	09:1 Final	09:2 Advance	From 08:3 to 08:4	From 08:4 to 09:1	From 09:1 to 09:2
GDP	13141.9	12925.4	12892.4	-5.4	-6.4	-1.0
CONSUMPTION	9195.3	9209.2	9180.5	-3.1	0.6	-1.2
DURABLE GOODS	1076.8	1087.2	1067.5	-20.3	3.9	-7.1
NONDURABLE GOODS	2026.1	2035.5	2022.4	-4.9	1.9	-2.5
SERVICES	6080.4	6076.0	6077.3	0.5	-0.3	0.1
INVESTMENT	1857.7	1558.5	1471.9	-24.2	-50.5	-20.4
FIXED INVESTMENT	1909.3	1687.5	1627.5	-20.2	-39.0	-13.5
NONRESIDENTIAL	1496.1	1321.2	1290.6	-19.5	-39.2	-8.9
STRUCTURES	484.0	419.4	409.8	-7.2	-43.6	-8.9
EQUIPMENT & SOFTWARE	993.7	887.5	866.9	-25.9	-36.4	-9.0
RESIDENTIAL	415.0	367.9	337.4	-23.2	-38.2	-29.3
CHG. BUS. INVENT.	-37.4	-113.9	-141.1			
NET EXPORTS	-470.9	-386.5	-339.3			
EXPORTS	1568.0	1434.5	1408.9	-19.5	-29.9	-7.0
IMPORTS	2038.9	1821.0	1748.2	-16.7	-36.4	-15.1
GOVERNMENT (Cons. & Invest.)	2544.0	2527.2	2562.1	1.2	-2.6	5.6
FEDERAL	1007.3	996.3	1022.4	6.5	-4.3	10.9
DEFENSE	681.7	672.8	694.1	3.8	-5.1	13.3
OTHER	325.4	323.4	328.1	12.7	-2.5	6.0
STATE AND LOCAL	1539.3	1533.3	1542.6	-2.0	-1.5	2.4
DISP. PERS. INC.	9920.4	9948.3	10027.2	3.4	1.1	3.2
FINAL SALES	13193.5	13055.8	13049.5	-4.7	-4.1	-0.2
FINAL SALES TO DOM. PURCHASERS	13654.9	13432.7	13381.6	-4.9	-6.4	-1.5
PRICE DEFLATORS:						
GDP CHAIN TYPE	109.2	109.7	109.7	0.1	1.9	0.2
GDP EX. FOOD & ENERGY				-0.8	0.5	1.1
PCE CHAIN TYPE	108.9	108.4	108.8	-5.0	-1.5	1.3
PCE EX. FOOD & ENERGY	107.9	108.2	108.7	0.8	1.1	2.0

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China: Lending or Pretending?

Aside from the $1 trillion-plus in fiscal stimulus flooding out of Washington these days, the other big spender hands-down is China. Beijing initiated its own massive $500 billion-plus spending package last year, and also set a target of at least 5 trillion yuan ($731.8 billion) for banks to lend out in 2009. The extra spending is already having an impact, but we find ourselves scratching our heads about how effective the second mandate has been, and what dangers might lie ahead.

The lending on its own has been nothing short of spectacular – during the first half of this year local banks issued over 7.37 trillion yuan in loans, well in excess of the government's preferred level for the year as a whole and tripling last year's lending pace of 2.45 trillion yuan. This rush of credit generation could easily peak at or above 10 trillion yuan for the whole of this year – double the government's request and surely enough to further stimulate economic growth. Or is it?

The July MNI Business Survey released today showed a mild improvement in China's economic conditions from 56.71 in June to 57.38. The subindices mostly showed minor gains, but one decliner in particular stood out. Current availability of credit dropped to 53.42 from 56.71 in June and a striking 61.22 in May. Furthermore, several companies commented on their surveys that they needed more credit for either expansion or survival. With Beijing so insistent on loaning money and banks so willing to issue the checks, why are conditions tightening and how are needy companies missing out on this financial free-for-all?

One scary possibility currently making the rounds is that the bulk of these loans have not financed capital formation as much as they have contributed to market speculation. Formally, loans cannot be issued for a spree on the Shenzen, but that does not mean it is not happening. Some have suggested that perhaps 2 trillion yuan so far has found its way onto the equity markets, with possibly a larger sum entering the speculative real estate market. Ever since the government announced its stimulus measures and a massive increase in lending, the Shenzen has been on a profitable run – a one-sided bet that smacks of speculation. Of course, it is possible that when Beijing publicized its efforts, market sentiment changed toward the better, thus driving the improvement. Quite likely, however, the answer is that both effects are in play right now. If the state-run Chinese media is broadcasting warnings about the inefficiencies of speculative investment, you know it must be a significant factor.

Chart 5

Stock Price Index: China: Dow Jones Shenzhen

Source: Wall Street Journal/Financial Times /Haver Analytics

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Speculation is an inherent evil of any market, and is usually kept in check by a degree of volatility that keeps traders honest. However, as it stands the Shenzen closed out this month up 33.0% on the year, up 104.3% from end-2008, and in the black by an amazing 147.7% since the market bottomed out on November 4 of last year. We cannot help but say this market is getting way too frothy for our liking.

Of course, the real problem lies in a scenario where all our supposition is true, followed at some point by the bubble bursting. China's banking system is still burdened to some degree by non-performing loans, although to what degree is hard to tell considering the opacity of the financial environment. What is apparent, though, is if most banks' loan books are already maxed out, a new wave of defaults would quickly lock up their ability to generate further credit. Undoubtedly the government would recapitalize these institutions, but considering the magnitude of potential loan losses, Beijing could end up with its own financial system meltdown. Who says China hasn't adopted the ways of the US markets?

Key Interest Rates

	7/31/2009	1-wk. change, bps	4-wk. change, bps	1-yr. change, bps
3-month Libor	0.48	-2	-8	-231
2-year U.S. Treasury note yield	1.12	7	14	-139
10-year U.S. Treasury note yield	3.50	-20	-1	-47

Global Economic Data

	Real GDP SAAR, yoy %		CPI NSA, yoy%		Unemployment Rate %		year-ago	Central Bank Rate %		year-ago
United States	-3.9	Q1-09	-1.4	May-09	9.5	Jun-09	5.6	0.13	Jun-09	2.00
Euro-Area	-4.9	Q1-09	-0.1	May-09	9.4	Jun-09	7.5	1.00	Jun-09	4.00
Japan	-8.4	Q1-09	-1.8	May-09	5.4	Jun-09	4.1	0.10	Jun-09	0.50
UK	-4.9	Q1-09	1.8	May-09	4.8	Jun-09	2.6	0.50	Jun-09	5.00
Australia	0.4	Q1-09	1.5	Q1-09	5.8	Jun-09	4.2	3.00	Jun-09	7.25
Canada	-2.1	Q1-09	-0.3	May-09	8.6	Jun-09	6.2	0.25	Jun-09	3.00
China	7.9	Q2-09	-1.6	May-09	4.3	Q2-09	4	0.81	May-09	2.53
India	5.7	Q1-09	9.3	May-09	--	--	--	3.25	Jun-09	6.00
New Zealand	-2.2	Q1-09	1.9	Q1-09	5.0	Q1-09	3.7	2.50	Jun-09	8.25
Norway	-0.3	Q1-09	3.4	May-09	3.1	Q1-09	2.5	1.25	Jun-09	5.75
Singapore	-3.7	Q1-09	-0.5	May-09	3.3	Q2-09	2.2	0.21	Jun-09	0.71
South Korea	-2.5	Q1-09	2.0	Jun-09	4.0	Jun-09	3.2	2.00	Jun-09	5.00
Sweden	-6.3	Q1-09	-0.8	May-09	8.0	Jun-09	6.6	0.50	Jun-09	4.25
Switzerland	-1.6	Q1-09	-1.0	May-09	3.8	Jun-09	2.5	0.40	Jun-09	2.79
Taiwan	-10.9	Q1-09	0.0	Jun-09	5.9	Jun-09	3.9	1.25	Jun-09	3.63
Thailand	-7.1	Q1-09	-4.0	Jun-09	1.8	May-09	1.3	1.75	Jun-09	3.75

* UK - Claimant Count Unemployment Rate

* Thailand - GDP Non-Seasonally Adjusted

* EA-13, UK, Sweden - Harmonized Unemployment